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No. 85-519

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1985

DR. WILLIAM C. RANDALL, DR. ROGER E. AUSTIN, DR. TOM W. ANDERSON and DR. MYREL A. NEUMANN,
Petitioners,

v.

B. J. LOFTSGAARDEN; ALOTEL INCORPORATED, a Minnesota corporation; PROPERTY DEVELOPMENT AND RESEARCH COMPANY, a Minnesota corporation; and 2361 BUILDING CORPORATION, a Minnesota corporation,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR ENVITEX REALTY CORP. AS AMICUS CURIAE IN OPPOSITION TO THE PETITIONERS

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QUESTION PRESENTED

Whether, in an action brought under the federal securities laws involving a tax shelter investment, the amount of damages recoverable by the tax shelter investor, if any, should be reduced by the amount of the permanent tax benefits that the tax shelter investor received as a direct result of his investment in the tax shelter?

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BRIEF FOR ENVITEX REALTY CORP. AS AMICUS CURIAE IN OPPOSITION TO THE PETITIONERS

Preliminary Statement

This brief is filed by Envitex Realty Corp. ("Envitex") as amicus curiae in opposition to the petitioners. It is filed with the consent of the petitioners and the respondents.

Interest of Amicus Curiae

Envitex's interest in this case ("*Loftsgaarden*") arises out of its position as a defendant-respondent in *Salcer v. Envicon Equities Corp.* ("*Salcer*"), an action

now pending before this Court on a petition for a writ of certiorari. 744 F.2d 933 (2d Cir. 1984), *petition for cert. filed*, 53 U.S.L.W. 3688 (U.S. March 13, 1985) (No. 84-1447).

In *Salcer*, plaintiffs alleged that Envitex had violated the Securities Exchange Act of 1934 (the "Exchange Act") in connection with the sale of limited partnership interests in a real estate tax shelter partnership (the "Partnership"). As an affirmative defense, Envitex asserted that plaintiffs had received cash and tax benefits in an aggregate amount that exceeded their out-of-pocket investment in the Partnership and that those receipts would have to be deducted from any claims for damages.

The *Salcer* plaintiffs moved to strike this defense on the ground that it was inadequate as a matter of law. The district court agreed and granted the motion. The United States Court of Appeals for the Second Circuit, however, reversed. The Second Circuit held that the motion to strike was granted prematurely and rejected the arguments of the plaintiffs as well as those of the Securities and Exchange Commission and United States' Department of Justice who appeared as amici curiae. The Second Circuit held that it was not, as a matter of law, improper to deduct permanent tax benefits from an award of damages under the Exchange Act.

The *Salcer* plaintiffs then petitioned this Court for a writ of certiorari, which petition is still pending. Because this Court's decision in *Loftsgaarden* may apply to all federal securities fraud cases involving tax shelter investments, including *Salcer*, Envitex's interests may be directly affected by that decision. Therefore, Envitex respectfully submits this brief for the Court's consideration.

Summary of Argument

Both the Eighth Circuit Court of Appeals in *Loftsgaarden* and the Second Circuit Court of Appeals in *Salcer* correctly held that, when a plaintiff alleges securities fraud in connection with a tax shelter investment, any damage award must be reduced by the amount of the permanent tax benefits that plaintiff received as a direct result of his investment. This rule is required by both the statutory language of the Exchange Act and a common sense analysis of the economic environment of tax shelter investments.

To pretend that permanent tax savings are not equivalent to dollars physically transferred to the investor, as the petitioners would have this Court believe, is preposterous. An investor's primary purpose in investing in a tax shelter is, more often than not, to save taxes. Thus, if permanent tax savings were not deducted from a damage award, a plaintiff would be permitted to purchase a tax shelter for the purpose of saving taxes, receive permanent tax savings in excess of his investment and then institute a law suit against persons associated with the tax shelter even though he had not lost a single dollar from his investment and had, in fact, achieved the compensatory purpose of his investment. Such a result is entirely inconsistent with the purpose of allowing private civil actions to be brought under the Exchange Act. The Exchange Act does not provide a mechanism for defrauded purchasers or sellers of securities to receive monies well in excess of any actual damages suffered as a direct result of their investment.

In an effort to persuade this Court to ignore the economic reality of tax sheltered investments, petitioners, and the United States and the Securities and Exchange Commission (the "Government") as amici curiae in support of petitioners, present a variety of arguments which

distort the reach as well as the principles of law underlying the holdings in *Loftsgaarden* and *Salcer*. The petitioners and the Government urge this Court to overturn the well-reasoned *Loftsgaarden* and *Salcer* decisions on the ground that these decisions adversely impact the deterrent value of private civil actions brought under the federal securities laws and on the ground that due to these decisions, defendants will be unjustly enriched at the expense of the nation's taxpayers. All of their arguments, however, fail to overcome the fundamental fairness of deducting from a damage award the very type of compensation sought by a purchaser of a tax sheltered investment, that is, permanent tax savings received in strict compliance with the tax laws of the United States. Accordingly, the petitioners' and Government's arguments must be rejected and the decision of the Eighth Circuit affirmed.

ARGUMENT

UNDER THE EXCHANGE ACT, PERMANENT TAX BENEFITS RECEIVED BY A PLAINTIFF MUST BE DEDUCTED FROM THE GROSS DAMAGES CLAIMED BY THE PLAINTIFF

A. The Exchange Act and Common Sense Support Deduction of Permanent Tax Benefits Received By Investors

Section 28(a) of the Exchange Act limits the amount of damages recoverable for violations of the Exchange Act to "actual damages." "Actual damages" are equivalent to a plaintiff's "net economic loss." *Marbury Management Inc. v. Kohn*, 470 F. Supp. 509, 516 (S.D.N.Y. 1979), *modified on other grounds*, 629 F.2d 705 (2d Cir.), *cert. denied sub nom. Wood Walker & Co. v. Marbury Management, Inc.*, 449 U.S. 1101 (1980). In addition, when a plaintiff cannot show that he has suffered any actual pecuniary loss, his claim under section 10(b) will be dismissed. *See Fershtman v. Schectman*,

450 F.2d 1357, 1361 (2d Cir. 1971), *cert. denied*, 405 U.S. 1066 (1972); *Levine v. Seilon, Inc.*, 439 F.2d 328, 335 (2d Cir. 1971).

Furthermore, it is well established that the purpose of an award of damages in common law actions for fraud or deceit is to place the plaintiff in the position he would have been in if the injury had not occurred. *Harris v. Standard Accident and Insurance Co.*, 297 F.2d 627, 631-32 (2d Cir. 1961), *cert. denied*, 369 U.S. 843 (1962); *Glidden Company v. Hellenic Lines, Ltd.*, 207 F. Supp. 262 (S.D.N.Y. 1962), *aff'd*, 315 F.2d 162 (2d Cir. 1963); C. McCormick, *Damages* §§ 121, 449 (1935); Restatement (Second) of Torts §901 (1979). Accordingly, a failure to deduct all benefits received by a plaintiff would award the plaintiff a windfall and place him in a *better* position than he would have been had he not made the investment. Such an award would be the equivalent of an award of punitive damages which is prohibited by section 28(a) of the Exchange Act. *Osofsky v. Zipf*, 645 F.2d 107 (2d Cir. 1981); *Byrnes v. Faulkner, Dawkins & Sullivan*, 550 F.2d 1303, 1313 (2d Cir. 1977); *Green v. Wolf Corp.*, 406 F.2d 291, 293 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969).

Applying these principles to this case or to other actions brought by allegedly defrauded investors in tax shelters under the Exchange Act requires that all permanent tax benefits received by the defrauded investors as a result of their investment be deducted from their claim for damages. The amount an investor is willing to pay for an interest in a tax shelter is a function of the perceived economic benefits, that is, the tax savings[1] as

1. "In general, a tax shelter is an investment in which a significant portion of the investor's return is derived from the realization of tax savings with respect to other income, as well as the receipt of tax-favored (or, potentially tax-exempt) income from the investment itself." Staff, Joint Committee on Taxation, *Proposals Relating To Tax Shelters and Other Tax-Motivated Transactions* 4 (1984).

well as any capital appreciation he expects to derive from that investment. Thus, such tax savings are part of each investor's anticipated economic return and must be deducted.

> Return from a tax sheltered investment will consist of cash flow, tax benefits, and equity buildup and appreciation equity value. The elements of return are normally interdependent.
>
> . . . . [I]f tax benefits are increased, such increase will be at the expense of cash flow, the appreciation potential and equity buildup. If either cash flow or appreciation potential are enhanced, such enhancement may be at the expense of the other return component.
>
> Since all four items of return are relevant, *no method of analyzing the rate of return on the investment should fail to take into account all of the components*.

R. Haft & P. Fass, 4 *Tax Sheltered Investments* Intro.-11 to Intro.-12 (3d ed. 1985 revised) (emphasis added).

Because of an investor's expected tax savings, it is not unusual for an asset, such as the hotel development in the *Loftsgaarden* case, or the real estate development in the *Salcer* case, to yield a higher sales price when incorporated into a tax shelter offering than when sold in a simple purchase and sale transaction. Nor is it surprising that the tax benefits hoped to be obtained by a prospective investor in a tax shelter are very much a factor in the overall bargain. Thus, it follows that if damages are to be assessed based upon such an investor's purchase price, it is only appropriate to consider those potential benefits actually received by the investor which induced him to pay that purchase price.

In short, the fact that an investment yields different kinds of benefits should not mean, as the petitioners and

the Government argue, that only one kind of benefit should be considered in computing damages.[2] As the Eighth Circuit stated below,

> all economic benefits bargained for and received must be deducted from plaintiffs' damages because 'the strictly compensatory nature of damages awarded in private securities fraud actions requires that such value be taken into account in determining whether and to what extent damages were inflicted upon plaintiffs.' *Austin I*, 675 F.2d at 182.

Loftsgaarden, 768 F.2d 949, 955 (8th Cir. 1985). In recognition of the value of permanent tax savings, the Second Circuit in *Salcer* declared:

> It is not within our power to ignore benefits bargained for and received by plaintiffs as a result of the transaction at issue, which represent real economic value mitigating any loss they may have suffered.

Salcer, supra, 744 F.2d at 940.

Therefore, as both the *Loftsgaarden* and *Salcer* courts determined, consideration of the permanent tax savings received from a tax shelter investment complies with the provisions of the federal securities laws concerning private civil actions and recognizes the economic reality that these permanent tax savings represent real value bargained for by the tax shelter investor.

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2. Similarly, if an investor purchases an interest in a claimed "gold and silver" mine for $100 and no mine exists, the investor was damaged in the amount of $100. But if the investor receives a silver mine that contains no gold, one must compute the value of the silver to determine whether the investor has been damaged.

B. The Arguments of Petitioners and the Government Are Not Persuasive Because They Ignore the Fundamental Fairness of Deducting Tax Benefits

In an attempt to persuade this Court to ignore the economic reality of tax sheltered investments and the fundamental fairness of deducting permanent tax savings from any damage awards concerning investments designed to produce these tax savings, petitioners and the Government set forth a variety of arguments based upon principles of common law, tax law and public policy. For the reasons set forth below, none of these arguments provide a basis for ignoring the permanent tax benefits actually received by an investor when calculating damage awards under the Exchange Act.

1. "Collateral Source" Rule

Petitioners and the Government argue that tax benefits received by plaintiffs must be ignored in calculating damages because tax benefits fall within the "collateral source" rule. This common law rule prohibits consideration of those benefits which are separate and distinct from plaintiffs' transactions with defendants and arise solely from unrelated third parties. However, as the Securities and Exchange Commission ("SEC") itself properly recognized in setting disclosure requirements for realty tax shelter offerings, tax benefits arising from such an investment are not separate and distinct from the investment but are the very essence of the offering.

In 1974, the SEC adopted Guide 60 as part of its Guide For The Preparation of Registration Statements. This Guide required the issuer to describe in detail the tax benefits which would accrue upon the sale or foreclosure of partnership property and upon the dissolution or liquidation of the partnership. Then, in 1982 the SEC

issued Industry Guide No. 5,[3] which superseded Guide 60 and required even greater disclosure of tax consequences.[4] Indeed, in accordance with the widely accepted precept that tax benefits are an inextricable part of a tax shelter offering, it has been held that the failure to properly advise investors of the appropriate tax effects of an investment in a tax shelter offering may itself constitute fraud. *See Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3rd Cir. 1981), *cert. denied*, 455 U.S. 938 (1982).

In light of the SEC's stringent disclosure requirements on issuers concerning the tax benefits relating to tax shelter offerings, it is somewhat puzzling for the SEC to now contend that a tax shelter investor's tax benefits are not the "direct product" of the investment or that the promoters play only a "partial and indirect role" in generating these permanent tax savings. (Government's Brief at pp. 13-14) The SEC's Guides mandating the disclosure to investors of all relevant tax consequences prove that the receipt of tax benefits is an inextricable part of a tax shelter offering and may not be said to fall within the ambit of the "collateral source" rule.

Moreover, whether or not there are tax benefits to be obtained in an investment of this sort ultimately depends on how the shelter is structured, operated and presented. Tax savings will result from the operation of a tax shelter only if such an operation is in compliance with the tax laws of the United States. Thus, tax shelter promoters, attorneys and accountants may be criminally liable under 18 U.S.C. § 1001 and 26 U.S.C. § 7206 if the actual

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3. SEC Release No. 33-6384 (March 16, 1982) (47 Fed. Reg. 11476).

4. These guidelines apply to all private offerings of real estate tax shelters. See Hooper Kanouff, Smith & Peryam, SEC Staff Interpretative Letter, available Oct. 11, 1982, in which the staff of the SEC assert that compliance with Regulation D requires the inclusion of tax opinions as specified in Industry Guide No. 5 in private offering memorandum in order to satisfy the disclosure requirements of Regulation D.

operations of a tax shelter do not comply with the tax laws which sanction their existence. It is extremely unlikely that in such criminal prosecutions, the Government will claim that the tax benefits generated by the investment were merely "collateral" and not the direct result of the defendants' acts. Therefore, it is inconsistent and unpersuasive for the Government and the petitioners to make such claims here.

2. Deterrence of Frand and Defendants' "Unjust Enrichment"

Petitioners and the Government argue that defendants will somehow unjustly "profit" at the expense of the Government if permanent tax savings are taken into account in awarding damages. They also urge that damages should not be mitigated by the tax benefits earned in order to encourage private Rule 10b-5 actions in the tax shelter area. Their arguments, however, are misleading and fail to comport with the realities of tax shelter investments and the underlying policies for allowing private actions under Rule 10b-5.

a. Consideration of Tax Benefits Delivered to Investors Does Not Undercut Rule 10b-5 As a Fraud Deterrent or Allow Fraud to Go Unpunished

The express purpose of the private civil remedies provisions of the federal securities laws is to compensate plaintiffs, not to penalize defendants. *Salcer*, *supra*, 744 F.2d at 941. Even though Congress could have chosen to penalize defendants in drafting provisions for private actions under the securities laws, it elected instead to permit defrauded investors to sue for the difference between what the investment initially cost and what it ultimately yielded, that is, for "actual" damages or rescission. Securities Exchange Act of 1933, §§ 11, 12, 15 U.S.C. §§ 77k, 77l; Securities Exchange Act of 1934, § 28, 15

U.S.C. §77bb. Thus, Congress, while allowing compensation for fraud, limits private federal securities fraud litigation to those claims in which actual economic losses have been suffered.

Obviously, penalizing fraud is a proper function of federal and state agencies. The methods that have been used by federal and state agencies to penalize tax shelter securities fraud have included: SEC injunctive and disgorgement actions; IRS injunctive actions; administrative proceedings by the SEC or IRS to prevent persons who have committed fraud from practicing before its agency; injunctive actions and actions for civil fines by state attorneys general; and criminal prosecutions, both state and federal, under a variety of state and federal statutes. Rule 10b-5, however, was not intended to provide one of the means for bringing a private civil action for fraud *per se*.[5]

Moreover, affirming the decision of the Eighth Circuit would not necessarily mean that permissible Rule 10b-5 claims by tax shelter investors would be significantly curtailed. Petitioners' argument that the *Loftsgaarden* decision will "discourage" investors from filing federal securities fraud actions because William

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5. Examples of fraud which are not actionable under Rule 10b-5 include: fraud which induces a plaintiff to hold, rather than to sell, a security, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); fraud which the particular plaintiff knew about, did not rely on or should have discovered, *Bartels v. Algonquin Properties, Ltd.*, 471 F. Supp. 1132 (D. Vt. 1979); *Meier v. Texas Int'l Drilling Funds, Inc.*, 441 F. Supp. 1056 (N.D. Ca. 1977); fraud which did not cause damages to the plaintiff, *Levine v. Seilon, supra*; fraudulent events occurring after the fact of a sale of a security to the plaintiff, *Morgan v. Prudential Funds, Inc.*, 446 F. Supp. 628 (S.D.N.Y. 1978); fraud committed by an "insider" of a tenderor who fails to disclose an imminent tender to sellers of a target company's stock, even though such fraud is punishable by criminal fine and imprisonment, *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5 (2d Cir. 1983), *cert. denied sub nom. Moss v. Newman*, 465 U.S. 1025 (1984).

Randall only recovered $506 completely ignores the compensatory purpose of private civil actions under these laws. (Petitioners' Brief at p. 35)

The facts in the case at bar and in *Salcer* are unusual because in both cases the permanent tax savings realized by the plaintiffs plus the cash recouped by the plaintiffs from their investment exceeded or nearly equaled the amount each plaintiff initially paid for his investment. This Court *should* discourage investors from filing federal securities fraud actions before they consult their accountants and determine whether or not they actually suffered any damages as a result of their investment. For the investor who has actually suffered damages, the *Loftsgaarden* decision will have no impact whatsoever on the investor's incentive or ability to institute a private civil action to recover those damages.

b. Defendants Do Not "Profit" From The Consideration of Tax Benefits In Computing Damages

Petitioners and the Government have erroneously argued that defendants will somehow "profit" unjustly if plaintiffs' tax savings are used to mitigate their damages. If this argument has any superficial appeal, it is only because the specter of "fraud" invokes the specter of undeserved "profit." Upon analysis, this argument has no substance.

The mere fact that defendants may pay less in damages simply means that plaintiffs did not actually suffer the full amount of damages claimed in their complaint, not that defendants are somehow unjustly enriched. Similarly, the Government's contention that defendants' liability is diminished "at the expense of the Nation's taxpayers" if tax savings are used to mitigate damages is absurd. None of the claims in this case or the *Salcer* case suggest that there was any fraud in connection with the tax shelter aspects of plaintiffs' investment activity. As noted by the Eighth Circuit below, the real estate projects involved in this case and *Salcer* strictly complied

with the provisions of the tax laws which provide tax benefits to persons who invested in these projects. *Loftsgaarden, supra*, 768 F.2d at 956. The "expense" to the Nation's taxpayers is exactly what the Government determined it should be in order to encourage the real estate development which actually occurred.

Properly stated, the issue here is "How much should plaintiffs recover?" Arguments premised on defendants' "profit" or "the expense to the Nation's taxpayers" are red herrings which seek to obscure the undeniable reality that plaintiffs have suffered only the minimal damages awarded by the Eighth Circuit in *Loftsgaarden*.

CONCLUSION

For all the reasons set forth above and for the reasons set forth in the brief submitted by respondents, this Court should affirm the decision of the Eighth Circuit.

Respectfully submitted,

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